

CHAPTER 17 NORTH KOREA

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Introduction. While North Korea's overall economic performance remains unimpressive, we have seen some improvement in a few pockets of the economy.

- Agricultural production has fallen sharply and famine is possible.
- On the other hand, there is evidence of growth in the non-farm sector,
- Meanwhile the euphoria of the North-South rapprochement has given way to increased tensions, with DPRK at odds with USG and ROK.

Famine and Economic Growth

North Korea's GDP grew in 2000, but at a much slower pace than the previous year.

- GDP was up 1.3% in 2000—but down from a 6.2% gain in 1999.¹
- In many ways, the picture is a mixed bag.

Bad News: Food Shortfall. Much of this slowdown is due to a collapse in agricultural production in 2000.

- Bad weather cut grain output by 15%.
- Rice production fell about 13% and corn and beans dropped 15%.

Possible Famine. Food insecurity is even worse in 2001.

- The UN World Food Program (WFP) is estimating a fall harvest 10-15% below last year's 3.0 million-ton (MT) harvest.
- About 4.8 MT are required to avert a nation-wide famine.
- Preliminary WFP estimates indicate North Korea's Fall 2001 harvest yielded about 2.6 MT of grain, the lowest level since the dismal harvest of 1997.

Humanitarian Crisis. Contrary to some reporting, the humanitarian crisis is not over.

- Food shortages continue in North Korea after a poor harvest last year and could grow worse with the recent drought, according to a 21 June 2001 statement

Figure 17-A. Selected Historical Data

\$ Billions (or %)	'97	'98	'99	'00
Gross National Income	17.7	12.6	..	..
Purchasing Power	..	21.8	22.6	22.0
Real Growth (%)	-6.8	-1.1	6.2	-3, 1.3
Inflation (%)	..	..	..	..
Exports	0.832	0.750	0.712	0.927
To U.S.	0	0	0	0
Imports	1.432	1.212	1.221	1.588
From U.S.	0.002	0.005	0.005	0.005
FDI from U.S.	..	..	..	..
In U.S.	..	..	..	..
Cur Account /GDP %	..	..	..	..
Fiscal Balance /GDP %	..	..	..	..
External Debt /GDP %	..	..	..	..

Sources: CIA, IMF, U.S. Commerce, Heritage Foundation

from Oh Jae-shik, co-chairman of the "Third Annual NGO Conference on Humanitarian Assistance to North Korea."

Needed: Emergency Food Aid. Emergency aid for North Korea is needed to avert the effects of drought and famine.

- Only 5% of a targeted \$3.26M donation for 2001 has been confirmed, according to a 22 June statement from Kathi Zellweger, Director of International Cooperation for Caritas, who coordinates international church aid for Hong Kong.

Non-Farm Growth. Things are better away from the farm.

- If we exclude agriculture, North Korea's GDP grew 4.4% in 2000.
- The construction and mining sectors each enjoyed a strong performance. Construction grew at 13.6% and mining grew at 5.8%.
- Trade rose by one-third to \$2.5B in 2000, due mainly to higher imports.
- If the North chooses to keep its doors open to foreign investments, North Korean economic growth would accelerate.

Operating Rates Up. On the positive side, factory-operations have reportedly increased.

- Aerial photographs taken recently of 69 North Korean industrial sites reportedly showed average operating rates of 77%, up from 46% 3 years earlier.²
- Oil refining and steel are also running at near full capacity, as are thermal power stations at 87.5%.

ROK Trade Up. Similarly, North-South trade volume is improving.³

- Border trade rose 27% in 2000 to \$425M.
- South Korea is the North's third largest trade partner, after China and Japan.
- The total includes south-north aid, which rose by 24.1%.
- Actual trade grew by 38.7%, in farm and fish products as well as processing on commission—where southern firms have garments and consumer electronics made up in the North for resale.

Economic and Foreign Policy

North's Economic Outreach. This surge in North-South economic cooperation reflected improving political relations in 2000. During 2000, DPRK Leader Kim Jong-il's distrust and hostility toward the rest of the world began to fade.⁴ He began to grasp the need for change in the economy.⁵

- The process began in March 2000 with Kim Jong-il's surprise appearance at a Chinese embassy reception in Pyongyang.
- That was followed by the historic North-South Summit in June of 2000.
- Kim Jong-il then sent his second-in-command, Marshal Jo Myong Rok, to Washington in October 2000 to meet then-President Bill Clinton.
- Secretary of State Madeleine Albright visited Pyongyang in October of 2000.

The Wind is Changing. What a difference a year makes. The euphoria of the June 2000 North-South summit is gone. In its place is a new DPRK economic Cold War posture vis-a-vis both USG and ROK. Kim Jong-il has recently used summits with his old Cold War allies, Russia and China, to strengthen traditional economic ties.

- A key commercial indicator of closer DPRK ties to China is trade. North Korea's trade volume with China rose 81% for the first half of 2001 compared to the same period last year.
- North Korea is also strengthening commercial ties to Russia by planning to link railways together.

U.S. Reassessment. Had time permitted, President Clinton may well have visited North Korea before the end of his presidency. That visit may have improved U.S.-DPRK economic relations, although there was certainly no guarantee that this would happen. See below.

- In any event, the new Bush administration understandably reassessed the U.S. economic strategy toward North Korea as part of an overall reassessment of U.S. national security strategy in Asia.
- When ROK's Kim Dae Jong's visit to Washington in March 2001, President Bush publicly voiced doubts about DPRK "trustworthiness" and suspended dialogue with North Korea.

No U.S. Dialogue. After a 3-month hiatus, President Bush blessed the resumption of a U.S. dialogue with North Korea in June 2001.

- But the U.S.-North Korean sparring at the ASEAN Regional Forum meeting in Vietnam in late June highlighted the diplomatic ground lost.
- Bottom line: The DPRK failed to respond to the U.S. offer to reopen the dialogue.
- More recently, President Bush included North Korea as part of the "axis of evil" in his State of the Union address in February 2002.

DPRK Hard-Line. The deterioration of U.S.-North Korean relations also provided the North a convenient excuse to slow down the pace of rapprochement with South Korea. But the downturn in U.S.-DPRK relations is not simply action-reaction. There were actually some signs that the DPRK was shrinking back from dialogue in Autumn 2000.

- Clearly North Korea was fearful of opening up too quickly.
- This new North Korean hard-line triggered delays or postponements in a number of important areas.
- The colder political climate has slowed the flow of South Korean economic aid and the pace of DPRK economic reform.

Impact on North-South Rapprochement.

- *Sunshine Policy.* The downturn in U.S.-DPRK relations prompted Kim Jong il to cancel his planned visit to South Korea. This was a blow to Kim Dae Jung's sunshine policy and his efforts to improve economic relations with North Korea.⁶ That in turn slowed down the already halting progress on two economic projects linked to North-South rapprochement:
- *Railway Stalled.* Plans for the planned reconnection of the rail and road links across the DMZ is running late due to North Korean delays and the South's refusal (for technical reasons) to meet the North's demand for instant electricity.
- *Hyundai Struggling.* Hyundai's North-South projects are struggling financially. For instance, Hyundai Asan, which organizes cruise tours from the South to the Mount Kumgang region of the North, has lost over \$300M to date. While the tours are politically pioneering, the company has failed to obtain a reduction in the \$12M monthly fee it must pay Pyongyang to operate them. Hyundai may also be unable to finance the project that it was hoping would recoup its cruise losses—a proposed large industrial estate near Kaesong, just north of the DMZ and not far from Seoul.
- *ROK Trade Down.* This deteriorating ROK-DPRK relationship also can be seen on the commercial front. In contrast to the 27.5% increase in ROK-DPRK trade in 2000, the value of inter-Korean trade actually fell by 31% year on year in the first two months of 2001.

IMF Aid? Given the stalled DPRK dialogue with the USG, perhaps the IMF can help get things moving.

- IMF said on 10 July 2001 that it is ready to provide aid to North Korea if Seoul and Pyongyang establish an open dialogue.
- IMF says it would like to send a fact-finding mission to North Korea to study how to help restructure its economy.
- The World Bank would also like to send a fact-finding mission to North Korea.
- What will be the World Bank focus?

Economic Strategy Formulation

The World Bank would presumably be addressing the following questions:

- How does DPRK rehabilitate the economy of North Korea?
- How does DPRK put the economy on a sustainable growth path?
- How does DPRK move away from a planned economy?
- How does DPRK pragmatically advance in practical ways the economic integration of the two Koreas?

Economic Challenges. Another way to think about these questions is to ask what challenges Kim Jong-il must face.⁷ They include the following:

1. Interaction with Market Economies. In the future, DPRK will have to develop expanded trade and investment relations with market economies. If the objective is to increase external economic relations and move toward Korean economic integration, then introducing market principles into DPRK's economic system is the only way to attain this objective.

- Therefore, it's necessary for North Korean economic policy makers to both learn about market economics and incorporate market thinking into their economic policies and institutions.
- There are huge challenges here in overcoming ideological biases, ignorance of economic and commercial practices, lack of businesslike behaviors, and institutional weaknesses.
- In the past, training of North Koreans in market economics and finance has been limited. This must change.
- Economic education and training will be a major need for policy makers, bureaucrats and enterprise managers. USG should help.
- North Koreans need to see economic logic, not just political logic in their foreign interactions. This will reduce misunderstandings and frustrations on both sides.

2. Infrastructure. Investment in North Korea's economic infrastructure is badly needed and will be a critical aspect of economic recovery. The investment requirements are huge. Therefore, putting the North Korean economy on a growth track will take lots of money. Unfortunately, there are real questions about:

- How to mobilize the required capital,
- How to prioritize projects,
- How to manage them well,
- And how to deal with North Korea's large existing external debt problem.
- On the positive side, Kim Dae Jung has stated his willingness to help rehabilitate North Korean infrastructure.
- However, South Korea is reeling from its own financial mess and will be hard pressed to deliver on Kim Dae Jung's lofty promises.
- Prime Minister Kim Dae Jong's sunshine policy is also under fire politically. The conservative opposition (GNP party) says the sunshine policy gives too much away to the North. It favors an increased emphasis on reciprocity.
- Kim Dae Jung also needs to get the Bush administration to wholeheartedly support ROK's economic integration with DPRK.

3. Economic Cooperation. The international community is moving away from humanitarian assistance and toward trade, investment and development assistance in DPRK. Toward this end, there needs to be new understandings about ways of interacting and working together.

- KEDO has proven an invaluable experience in what it means to work in partnership with North Koreans. But there are many difficult KEDO issues.
- Increasingly diversified economic relations places strains on DPRK government to adapt to new requirements and expectations of development partners.
- New mechanisms are needed to support coordination of dialogue on practical issues involved with development assistance and private investment.
- The agreements made at the Summit are the first step in what will arguably be a long and winding road.

4. Commercial and Businesslike Practices.

North Koreans need to learn good commercial and businesslike practices in their relations with foreign investors and donors. To help North Korea successfully integrate, old politically motivated investments in DPRK that lack a basic economic and commercial logic must be scrapped. Simply put, teaching bad habits is the wrong way to go. Unfortunately, many existing projects in North Korea cannot pass this strict economic viability test.

- This applies both to the commercial ventures and also to KEDO. There is a need to introduce economic rationality into engagement with North Korea.
- In contrast, positive activities that will most help North Korea and need to be expanded upon include the UNDP and other UN agency projects, both in agriculture rehabilitation and in the Rajin-Sonbon Free Enterprise Zone.

5. Social Gap. A gap exists between economic reality in DPRK and North Korea's formal social policies. This poses a huge challenge. Not only can the State not provide basic human services to the population. But its ability even to feed and clothe the large urban population has been eroded by the breakdown of the State distribution system.

- The State's inability to deliver basic social services and consumption needs for its people have led to the emergence of an unofficial market economy.
- This market economy is fulfilling a social function of enabling the population to satisfy some of their basic needs through the market rather than the State.
- About 70-80% of the consumption of the urban population is now met through these markets that sell not only food but also many basic commodities.
- The State has tolerated a proliferation of these markets around the country—now estimated to have reached over 300.
- But their existence and growth is evidence of a new parallel economy emerging in North Korea that is guided by very different behavior and principles than the official economy.

Weaker Social Control. This also has major significance for social control and the relationship of the State to the people of North Korea. As the country opens up to external investment and development assistance, the impact on these social dynamics poses major questions:

- How North Korea will reconcile its internal and external policies and objectives?
- The social gap poses a real threat to social cohesion and future political developments.
- A large perception gap also exists between external reality and the understanding of the world of most ordinary North Koreans.
- This gap is likely to affect the dynamics of North Korean policy and official behavior in ways that inhibit fulfillment of many of the hopes expressed at the Summit.

6. Three Economic Systems. In addition, a big challenge is how the internal economic systems within North Korea are going to evolve over time. It seems clear that there are now three coexistent economic systems.

- First is the official state-controlled economy—mainly comprising state enterprises and cooperatives managed through the state budget and state distribution system.
- Second is the military economy, which has its own production and welfare distribution framework.
- And the third is the young and fragile informal free market economy, which as noted earlier is playing an important social role in the present distressed situation.

7. Military Resources. In addition there are a number of other key issues for the future:

- How will the resources that flow into North Korea—from South Korean ventures, official development assistance, or from other foreign sources—be distributed among these three sub systems within North Korea?
- And what will this mean for the future political economy of the country?
- Security concerns. Most importantly, we don't want economic resources to flow into

and strengthen the North Korean military economy, thereby weakening USG/ROK strategic deterrence capability.

- These internal issues and dynamics entail great uncertainty and are good cause for caution in projecting the path for the future.

8. Policy and Institutional Constraints. Even if these issues can be responsibly addressed, policies and institutions must be reshaped if infrastructure investments are going to yield the economic returns expected.

- While North Koreans may be shy about the word “reform” they seem to be more pragmatic in accepting the need for modernizing economic management.
- It is impossible to imagine how North Korea will be able to design and implement a successful economic recovery policy—even with significant financial support from the South—without finding a way to understand and come to grips with the policy and institutional constraints that they face.

Prices and Currency. Addressing macro-economic policy issues is also unavoidable in order to send better signals through the economy for efficient allocation of resources and create an environment that will inspire investor confidence.

- A key issue is pricing policy and the overvaluation of the exchange rate.
- The official exchange rate is about 2 Won to the dollar, while the unofficial rate is 200.
- Without proper pricing, it will be impossible to proceed very far with real economic rehabilitation or cooperation.

German Mistakes.⁸ In this regard, the recent German experience provides some insight Bonn made a number of costly mistakes: It:

- Pandered to East German consumers,
- Overvalued the Ostmark (East German currency) at the time of monetary conversion,
- Created virtual wage parity between East and West Germans, and

- Destroyed the competitive position of all East German producers.

Ensuing European Disaster. These mistakes, in turn, triggered:

- Huge subsidies for collapsing East German industries,
- Bonn over-borrowed to pay for unity mistakes,
- Bonn opted for an irresponsibly loose fiscal policy (high budget deficits), which was inflationary.
- The Bundesbank offset inflationary pressures with high interest rates (monetary death grip), which in turn triggered:
 - A deeper recession in Europe,
 - European financial chaos,
 - And political disunity in Europe.
 - In short, the hasty, hysterical German unification process was a disaster.
- To avoid a similar disaster, Seoul and Pyongyang must carefully address the terms and conditions of their economic integration.

9. Legal and Financial Infrastructure. A free market oriented economy also requires a strong financial and legal foundation.

- In this regard, a positive sign of recognizing the importance of this “economic software” was the agreement during Summit for the two Koreas to start work on problems of a) financial settlement, b) guarantee of investment, c) prevention of double taxation and d) arbitration of disputes.
- Frankly, the legal and financial infrastructure for economic cooperation is just as important as the money.
- Over time, technical assistance to help develop more modern capabilities in these areas and many others will be an important part of the strategy to realize the future vision articulated at the Summit.

IFIs To a large extent, the success or failure of North Korea’s economic transformation will also turn on how the International Financial Institutions (IFIs)—IMF, the World Bank and the Asian Development Bank—interact with

the key countries that play pivotal roles on the Korean peninsula.

ROK’s Green Light. Kim Dae Jung and the South Korea government have been supportive of North Korea developing relations with the IFIs for some years. Since the Berlin speech, Kim Dae Jung has made numerous references in his public pronouncements about this.

US and Japanese Security Concerns The USG and Japan are the two largest shareholders in all the IFIs and have a big impact on IFI policy.

- In the past, USG and Japan concerns about security issues—missiles and nuclear program—have worked against North Korean efforts to develop relations with the IFIs.
- In the case of the US, the fact that North Korea is still on the terrorist list means that Treasury is obligated under US law to oppose any IFI expenditure of resources for North Korea.

DPRK. Even if the other key countries agree to promote IFI participation, North Korea’s must unequivocally seek IFI assessment and advice on the issues faced by other countries in transition from planned to market economies.

- But this requires a willingness to open up and share information that has been closely guarded in the past.
- As of today, it is not at all clear that the North Koreans are ready to take this step, even if they have been willing to induce some economic management changes of their own making in recent months.
- In other words, the North Koreans seem to want access to IFI advice, technical assistance and financial resources. But they are hesitant about the terms and conditions that IFIs bring into official agreements and the requirement for transparency in access to information and policy dialogue.
- So some kind of understanding about the benefits of DPRK membership and overall process of how these could be obtained is still required.

IFI Bottom Line. Thus the Summit and Kim Jong Il's trip to China provide an important boost to the possibility of a future role for the IFIs on the Korean peninsula.

- IFIs are critical to orchestration of serious DPRK economic reform.
- But the progress in DPRK relations with the US and Japan will also have a decisive impact on the timing and scope of support for future IFI involvement.

Getting Agreement

Common Principles. The first things that are needed are common principles agreeable to both sides:

- Any economic integration must be peaceful and non-threatening.
- This means military as well as economic and political aspects must be addressed as a seamless web.
- Realistically, the model of economic development must be a Chinese one. Any attempt to democratize in the early part of the process would be threatening to DPRK leadership that is already hard pressed to implement free market reforms.
- Finally, economic reunification must be a step by step process. In this regard, both Koreas share the same goal of economic integration. But they are miles apart in many areas. Therefore, the process must be gradual and step by step.

Economic Goals. Both sides must also agree on how to shape economic integration.

- On the micro-economic side, the first goal must be to strengthen the self-sustaining viability of North Korean industries that still exist. That means keeping North Korea's currency weak at the time of conversion.
- Deepen and consolidate South Korean economic reforms.
- Don't bite off more than you can chew in North Korea. Focus on a few key economic zones in North Korea. Pockets of success will create further success.
- Create a viable and robust social safety net (unemployment benefits) to absorb the rising number of jobless North Koreans.

Four-phased Unity. Then Seoul and Pyongyang need to develop a four phase economic and monetary process:

- Adopt Chinese style laws and institutions, stabilize macro-economy, and create a free trade area. Avoid abrupt initial attempts at democracy in North Korea.
- Liberalize domestic prices, move toward convertibility of currency and let it float. Form a Korean Community (much like the old European Community). Pyongyang maintains political sovereignty while surrendering parts of its economic sovereignty.
- Form a German style political federation. Move to one currency and one central bank.
- Move to full economic and monetary unification (e.g., common budget) and free elections.

Perry Process. Thankfully, Washington does not have to start flat-footed on détente with North Korea. Dr. William Perry, former Secretary of Defense in the Clinton administration, started much of the ground-breaking work on developing a grand strategy that would culminate in reconciliation with North Korea.

- Dr. Perry visited North Korea and wrote a report outlining a new US strategy toward North Korea.
- While the Perry Report is classified, it's fair to say that the report contributed to President Clinton's ensuing decision to ease economic sanctions toward Pyongyang. President Clinton's actions created a new strategic setting for the Korean peninsula.
- In this sense, Dr. Perry's new policy initiatives were not simply narrow or arcane economic actions. In fact, they formed a seamless web with the other elements of comprehensive security for the Korean peninsula.

Stake in Stability. In this regard, we need to do everything possible to:

- Revive the northern economy and give the country a stake in stability.
- Encourage foreign investment.

- Foreign investment in turn will generate export earnings as an alternative to the dangerous sale of its missiles.
- Foreign investment will also give DPRK leadership rational alternatives in the future.

Paving the Way to Peace. Given slow progress in Four-Party Peace Talks in Geneva, economic integration is both a more likely route and a precondition for peace.

- Seoul and Pyongyang need to build on their positive start in the reconciliation and engagement process, which in turn could rapidly trigger moves toward deeper economic integration.

Quid Pro Quo. North Korea will always be difficult to deal with. But encouragement should be given to the process of opening its economic doors.

- In return, it is reasonable to demand more civilized behavior from Pyongyang. Being integrated into the outside world should help ensure that process.
- In short, it's time to give economic integration a chance to reduce tensions and pave the road to peace.

Crisis Prevention. To avoid a haphazard process, USG should do the following:

- Work closely with Beijing, Seoul, Tokyo and Pyongyang to come up with measured integration plans.
- Once thoughtful plans are in place, Seoul and Pyongyang can concentrate on the arduous and politically agonizing process of implementation.
- If the key actors choose to procrastinate planning for economic integration, the USG could find themselves both flat-footed and reacting hysterically.
- That would be a recipe for economic disaster for Korea and the rest of Asia. If that occurs the world would look to the USG for the distasteful job of crisis management.
- A better strategy would have been careful and early planning for economic integration and policy coordination as a means of crisis prevention.

Conclusions

North Korea's economic performance is something of a mixed bag.

- On the negative side, we see a severe food shortfall this year and a possible famine unless the international donor community can increase emergency food aid. So unfortunately, the humanitarian crisis in North Korea is still with us.
- The situation is better away from the farm. We actually see some economic growth in other sectors of the economy.

Overall, the economy remains dirt poor. Without market reforms, the economy cannot recover. Meanwhile, North Korea is slowly reforming its economy.

- For instance, North Korea has pursued economic and political outreach, both unthinkable not long ago. It now has diplomatic relations with a number of countries.
- But in 2001 a new Cold War has hardened DPRK's posture, despite Seoul's efforts to revive its sunshine policy.
- As a result, North Korea is even less likely to implement any comprehensive economic reform in the near future.

Endnotes

- 1 South Korean Central Bank. The bank does not include the military economy—arguably bigger than its civilian counterpart. It also does not calculate the growing role of unofficial private enterprise and markets. If the private sector were included, GDP would be much higher.
- 2 *Economist Intelligence Unit*, May 2001.
- 3 The trade figures cited earlier exclude inter-Korean trade, which Seoul calculates on an internal basis.
- 4 I want to thank Mr. Nay Htun, formerly Assistant Secretary General at the United Nations Development Program (UNDP) and his North Korean expert, Mr. David Fennel, for their collegial support and their insight into the economic changes developing in North Korea.
- 5 But the North Korean economic challenge is what to do and the method of implementation of economic reforms.
- 6 To make matters worse, a series of domestic policy blunders have also caused the popularity of Kim Dae Jung to plummet.